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Comments on Draft Guidelines
c/o Division of Local Finance
1700 James K. Polk State Office Building
505 Deaderick Street
Nashville, TN 37243-1402
By email: comptroller.web@tn.gov

Dear Sir or Madam:

Thank you for the opportunity to comment on "Guidelines for Interest Rate and Forward Purchase Agreements." The current document is a great improvement and the municipal finance industry is clearly in need of structural changes. Please contact me if I can answer any questions related to these comments or can serve you in any way.

Comments:

1. The overall approach to regulating these products is atomistic as opposed to holistic. The atomistic approach views the financial instrument and possibly a corresponding debt security in isolation to the rest of the municipal entity. The holistic approach views the financial instrument within the context of the entire municipal entity. Quality regulatory structure would seek to address both the atomistic issues as well as the holistic issues. Hedging financial risk only makes sense within a holistic approach. It is impossible to determine whether a particular transaction is a 'hedge' or not from an atomistic approach. I found no enterprise wide risk management view in this document.

2. Very few municipal entities attempt to understand the interest rate sensitivity of the asset side of their balance sheet. In fact, many municipal finance personnel do not fully appreciate the nature of the asset structure of the municipal entity (for example, tax revenue sources as opposed to brick and mortar). Identification of whether a particular financial instrument transaction is risk increasing or risk decreasing hinges on careful inclusion of the interest rate sensitivity of the municipal entity's assets. I found very little discussion of asset inclusion in this document.

3. Quality debt management of a municipal entity should focus on two issues, the overall quantity of debt and its related costs as well as the overall risk exposures created by the debt. Regulators should consider whether or not it makes sense to create benchmarks by which to judge the quality of the municipal entity's debt management. This is particularly important for entity's that engage in view-driven debt transactions (trying to time the market) as opposed to needs-driven (traditional asset-liability management). Benchmarking would enable regulators and municipal entities to better understand the economic costs of their actions (particularly active trading).

4. III. D. 1. a. It is unclear why the amortization structure of the underlying debt is a concern. It does matter that the financial derivative contract match the amortization structure of the debt, assuming there is a compelling interest in matching.

5. III. G. 1. The "average coupon rate it would have paid on a fixed-rate bond issue" is purely a hypothetical number. Regulators should be concerned that the party providing this estimate is not conflicted.

6. IV. A. 1. As the financial derivatives market matures, it should be able to efficiently provide swaps with less than $50,000,000 notional. The regulatory focus should be on overall costs, not notional amount.

7. IV. A. 4. a. 1.) b.) 100 basis points is arbitrary. It may be better to remain vague and compel the municipal entity to justify the transaction. These arbitrary numbers show up in a variety of places, not mentioned here in my comments.

8. IV. A. 4. b. 2.) 200 basis points when? Issuing fixed and swapping to floating will then only be feasible when the yield curve is steep. It is unclear to me why permitting synthetic floating only when the yield curve is steep is reasonable (may actually be the precise wrong time due to the indicated business cycle stage). Also, are the only qualified assets 'underlying short-term investments'? Municipal entities have numerous other assets that are interest rate sensitive, such as future tax receipts.

9. IV. A. 5. a. Financial instruments should be permitted for asset-liability management purposes for those municipal entities that have outperformed their benchmarks.

10. IV. A. 5. b. Five years is arbitrary and atomistic. Municipal entities may be forced to have much larger notional amounts to offset this restriction.

11. IV. A. 5. h. The term 'speculative' is vacuous from an atomistic perspective.

12. IV. A. 5. h. Swaptions can be used to hedge from a enterprise perspective. It appears the regulatory position is that swaptions are speculative. If this is true,

then no municipal bonds should be permitted to have an embedded call feature because that is nothing more than the municipality purchasing a receiver swaption.

13. IV. B. There are a few typos I assume here. Line 5, ‘the’ should be deleted. Line 10, ‘Entity’ should be added after ‘to support the Governmental’. Line 14, ‘Independent’ is missing before ‘Swap Counsel may be used in’.

14. IV. B. Is the intention here that the Government Entity has to retain two separate independent swap advisors, one for the transaction and one for the subsequent analysis?

15. IV. C. Should regulators state a preference for competitive bidding process? Negotiation appears to be expensive in many cases.

16. IV. G. Line 9, something is missing at the end of this line ‘refunding of the specific identifiable’ …

17. IV. H. The counterparty is conflicted in providing monthly mark-to-market calculations of the derivative contracts and security collateral. Some form of independent verification should be required.

18. V. Quantity risk is a major risk with forward purchase agreements. An adverse movement in interest rates combined with no longer needing the financing is a recipe for disaster. Municipal entities should be forced to carefully document the severe adverse consequences of quantity risk.

19. V. A. 2. How is ‘reasonably anticipated’ determined? After the fact analysis is wrong.

20. V. B. Line 3: ‘business purpose account the’ should be ‘business purpose and account for’

21. V. C. Should regulators state a preference for competitive bidding process? Negotiation appears to be so expensive in many cases.

Sincerely,

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